DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0712
INDIANA CORPORATION INCOME TAX
For Tax Years 1994 and 1995

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ISSUES

I. **Distributive Share of Corporate Partner**: Including Partner's Loss as a Portion of the Distributive Share of a Corporate Partner.

Authority: 45 IAC 1-1-17; 45 IAC 1-1-159.1; I.R.C. § 704.

The taxpayer has protested the auditor's calculation of its gross income tax base. Taxpayer maintains that the auditor improperly failed to include a distributive share of partnership loss.

II. **Allocation of Income From Corporate Partners**: Direct Allocation of Partner's Income to the Corporate Partners.

Authority: IC 6-3-2-2; IC 6-3-2-2(l); IC 6-3-2-2(p); IC 6-3-2-2(q); Allied-Signal, Inc. v. Director, Div. Of Taxation, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); 45 IAC 3.1-1-153(b); 45 IAC 3.1-1-153(c).

The taxpayer has protested the adjustment to its adjusted gross income tax base. The auditor determined there was no flow of goods and services between taxpayer and its corporate partners sufficient to provide evidence of a unitary business relationship. Taxpayer argues that a unitary relationship exists between the corporate partners since the primary function of each corporate partner is to hold an interest in their respective partnerships.

III. **Abatement of 10 Percent Negligence Penalty**: Reasonable Cause for Abatement.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(c).

The taxpayer protests the assessment of the 10 percent negligence penalty believing that its determination of tax liability, however erroneous, was reasonable and that the Department should exercise its discretion to abate the consequent penalty.

STATEMENT OF FACTS

Taxpayer is a multi-media conglomerate consisting of numerous divisions, partnerships, and subsidiaries. The taxpayer provides entertainment, telecommunications, broadcasting, and publishing services. The taxpayer has business sites located within the state of Indiana.

DISCUSSION

I. Distributive Share of Corporate Partner.

The taxpayer protests the Department's calculation of its gross income tax base. The taxpayer argues that distributive shares of partnership losses should have been included in the calculation of its gross income tax. The taxpayer maintains that under 45 IAC 1-1-159.1, a partner's distributive share includes the amount as determined under I.R.C. § 704. According to the taxpayer, the partners' distributive share under I.R.C. § 704 clearly includes a partnership's distributive share of income or loss.

The taxpayer is correct in its initial assertion. 45 IAC 1-1-159.1(a) defines the distributive share of a corporate partner as "the amount determined under Section 704 of the Internal Revenue Code and its prescribed regulations *before any modifications required by Indiana tax statutes*." (Emphasis added) The taxpayer is correct in its second assertion. I.R.C. § 704 does specifically make reference to a partner's distributive share as including "income, gain, loss, deduction with respect to property contributed to the partnership." I.R.C. § 704(c)(1)(A).

However, taxpayer errs in its ultimate conclusion because it ignores the supervening definition of "gross income" as set forth within the Department's regulations. 45 IAC 1-1-17 defines gross income as "the entire amount of gross income received by a taxpayer. This includes all income actually or constructively received . . . ." The regulation continues by stating that "[a]mounts received or credited include not only cash and checks but notes or other property of any value or kind, services of any value or kind and receipts in any form received by or credited to the taxpayer in lieu of cash." Id. Accordingly, the state's gross income tax is applied to "the entire amount of gross income received by a taxpayer," and does not include a partnership's distributive share of *losses*. Although the statutes related to the state's gross income taxes contain certain specific exemptions and qualifications, they are inapplicable to the taxpayer.

FINDING

The taxpayer's protest is respectfully denied.

II. Allocation of Income From Corporate Partners.

Audit determined that the taxpayer's corporate activities and the partnership's activities did not constitute a unitary business under established standards because there was no apparent flow of goods and services between taxpayer and its partnerships.

Taxpayer maintains that three of its corporate partners (hereinafter Partner 1, Partner 2, and Partner 3) are unitary with the taxpayer for the purpose of determining the taxpayer's Indiana adjusted gross income tax. Partner 1 and Partner 2 are described as holding companies, "special purpose corporation[s] formed for the primary function of holding a partnership interest." Partner 1 and Partner 2 were formed for the purpose of holding telecommunication assets in order to assure taxpayer's compliance with a court ordered divestiture.

Partner 3 is a direct marketer of consumer music products which are sold by mail order and the Internet. Partner 3 purchases and distributes certain music products produced by taxpayer's other subsidiaries. According to the taxpayer, "there is clearly a flow of goods between [Partner 3] and the [taxpayer's] corporate entities."

45 IAC 3.1-1-153(b) is relevant to taxpayer's assertion and provides that "[i]f the corporate partner's activities and the partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula consisting of property, payroll, and sales of the corporate partner and its share of the partnership's factors . . . ." Alternatively, 45 IAC 3.1-1-153(c) sets out the means of attributing partnership income in those situations in which the corporate partner's activities and the partnership's activities do not demonstrate a unitary business relationship.

The issues of what constitutes a unitary relationship has been addressed by the Supreme Court. As defined by that Court, the hallmark of a unitary relationship is that there must be "some sharing of exchange or value not capable of precise identification or measurement-beyond the mere flow of funds arising out of passive investment or a distinct business operation-which renders formula apportionment a reasonable method of taxation." Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166 (1983). In conducting a "unitary relationship" analysis, the Court will determine whether contributions to income of the subsidiary results from functional integration, centralization of management, and economies of scale. This means that the parties exhibit common ownership, common management, and common use or operation. Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 438-40 (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 317 (1982); F.W. Woolworth Co. v.

Taxation and Revenue Dept., 458 U.S. 354, 365 (1982); Container Corp. 463 U.S. at 179 (1983); Allied-Signal, Inc. v. Director, Div. Of Taxation, 112 S.Ct. 2251, 2263-64 (1992).

Taxpayer asserts that Partner 1 and Partner 2 – taxpayer's two holding companies – are integral to taxpayer's operations and that "it is clear that there is a flow of goods and services" between Partner 1 and Partner 2. The Department is led to a differing conclusion. Other than taxpayer's bare assertion to the contrary, taxpayer has failed to provide substantive, specific evidence of a flow of goods or services between taxpayer and the two Partner holding companies which would "render formula apportionment a reasonable method of taxation." Container Corp. 463 U.S. at 166.

Taxpayer has offered certain evidence demonstrating a flow of goods between taxpayer's various divisions and Partner 3. As a distributor of recorded music, Partner 3 distributes products which are produced by various other taxpayer subsidiaries. Partner 3 distributes music products (CDs and cassette tapes) which are produced by three record labels owned by the taxpayer. Partner 3 distributes music products which are manufactured by one of taxpayer's subsidiaries. Partner 3 distributes CD packaging materials which are printed by one of the taxpayer's other subsidiaries. Accordingly, taxpayer has provided information demonstrating a certain – if unverified – flow through of goods and services between itself, taxpayer's various subsidiaries, and Partner 3.

However, taxpayer is required to demonstrate more than an incidental flow of goods and services between itself, its various subsidiaries, and Partner 3. In determining whether the taxpayer has demonstrated the requisite hallmarks of "functional integration, centralization of management and economies of scale," (Allied Signal 112 S.Ct. at 2264) the Court in Container Corp. 463 U.S. 159, stated that these hallmarks could be established by evidence of transactions not undertaken at arms length, 463 U.S. at 180, a management role by the parent which is grounded in its own operational expertise and operational strategy, Id., and the fact that the corporations are engaged in the same line of business. Id. at 178. Other than generalized assertions describing the relationship between itself and its numerous divisions and corporate partners, taxpayer has provided little upon which to base a determination that the hallmarks of a unitary relationship are present between itself and Partner 3.

FINDING

Taxpayer's protest is respectfully denied.

III. Abatement of 10 Percent Negligence Penalty.

Taxpayer has requested that the Department to exercise its discretionary authority to abate the ten-percent negligence penalty assessed pursuant to IC 6-8.1-10-2.1. According to the taxpayer, the additional tax due was based primarily on an audit adjustment made

to include the distribute share of certain partnership income in the gross income tax base of the taxpayer's corporate partners. Taxpayer initially reported the distributive share of the partnership income in the gross income tax base of the corporate partners at the high rate but then erroneously subtracted the entire amount as nontaxable receipts in an attempt to exclude sales outside of Indiana. Taxpayer asserts that it made a good faith effort prepare its return and that "clearly there was no willful neglect of the pertinent laws and regulations."

Under IC 6-8.1-10-2.1(d), the Department is empowered to waive the ten-percent negligence penalty if the taxpayer can establish that its failure to pay the tax deficiency was due to reasonable cause and not due to willful neglect. Under 45 IAC 15-11-2(c), in order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying our failing to carry out a duty giving rise to the penalty imposed. Ignorance of the listed tax laws, rules, and/or regulations is treated as negligence.

Factors which may be considered to determine reasonable cause include the nature of the tax involved, judicial precedents set by Indiana courts, judicial precedents established by jurisdictions outside Indiana, published Department instructions, information bulletins, letters of findings, rulings, and letters of advice. 45 IAC 15-11-2(c).

Even assuming that taxpayer's failure to pay the appropriate amount of tax was entirely attributable to an innocent mistake, taxpayer is unable to establish a "reasonable cause" for that error. Taxpayer is a sophisticated and experienced business entity fully able to calculate – with a reasonable degree of precision – its state tax liabilities. Taxpayer can point to no precedents, instructions, bulletins, statutes, or regulations which justifies its failure to pay the full amount of its state tax.

FINDING

Taxpayer's protest is respectfully denied.